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September 17, 2013

EX PARTE **PRESENTATION – VIA ECFS**

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: *Telephone Number Portability, et al.*, CC Docket No. 95-116; WC Docket Nos. 09-109, 07-149

Dear Ms. Dortch:

On behalf of a client who does not wish to be identified, I previously wrote to the co-chairmen of NAPM to ensure that they were aware of the exorbitant profits that the current Local Number Portability Administrator ("LNPA"), Neustar, Inc., is earning under the existing Number Portability Administration Center contract ("NPAC Contract"), and to urge them to substantially reduce the fees earned by the next LNPA(s) through the ongoing vendor selection process. NAPM subsequently filed the letter in the above-referenced proceeding. Consistent with that filing, and in the interest of transparency, I am submitting the further correspondence attached hereto for the public record.

Just as NAPM should carefully scrutinize the information provided in the attached correspondence and with my previous letter, so too should the Commission consider that information in its oversight role regarding the LNPA selection process. In particular, the Commission should exercise its authority to ensure that the final NPAC Contract advances the public interest and avoids providing excessive compensation to the next LNPA(s). The financial information provided herein and submitted with my initial letter is intended to assist the Commission and NAPM in achieving that objective.

Respectfully submitted,

/s/ Matthew A. Brill

Matthew A. Brill
of LATHAM & WATKINS LLP

Attachment

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September 17, 2013

VIA EMAIL & FEDERAL EXPRESS

Melvin Clay
AT&T
675 West Peachtree Street, NW
Atlanta, GA 30375

Timothy Decker
Verizon
600 Hidden Ridge
Irving, TX 75038

Re: Additional Considerations for NAPM's Selection of the Next LNPA(s)

Dear Messrs. Clay and Decker:

I am writing to follow up on my letter of August 16, 2013 regarding NAPM's ongoing vendor selection process for the next Local Number Portability Administrator(s) ("LNPA(s)"). Building on the analysis provided in the previous letter, my client has prepared a "fair price analysis" designed to assist NAPM in selecting one or more LNPAs. This fair price analysis illustrates a range of achievable prices for the next Number Portability Administration Center contract ("NPAC Contract"), taking into account the estimates of operating costs provided in my August 16 letter, combined with informed estimates of the required upfront capital investments. **Specifically, my client estimates that using the "High Case" from the August 16 letter, which as noted is believed to be a more accurate estimate than the "Low Case," a contract price of less than $150 million per year would enable the next LNPA(s) to achieve attractive returns on sales and capital that are consistent with, if not superior to, relevant benchmarks for appropriate returns on investment on quasi-governmental contracts, while also realizing significant savings for NAPM's members—and, as a result, their customers and shareholders.**

An NPAC Contract price at or above $150 million would serve only to enrich the next LNPA(s) while imposing unnecessary costs on NAPM's members and, more importantly, their customers.[1] NAPM therefore should view any "best and final" offer that exceeds this amount

[1] The charges imposed on carriers under the NPAC Contract ultimately are borne by consumers. *See*, *e.g.*, AT&T Wireless, Additional Charges, http://www.wireless.att.com/cell-phone-service/additionalcharges/?txtzip=96818 (last

with significant skepticism. As NAPM considers bidders' proposals, it should ensure that the profit margins they would yield conform to more appropriate expectations for this type of quasi-governmental contract. Established federal policies provide relevant benchmarks that NAPM should consider in evaluating the best and final offers.

First, NAPM should consider the profit margin targets set for government contractors, given the quasi-governmental nature of the NPAC Contract (in light of the FCC's oversight role and the imposition of mandatory fees on telephone ratepayers). Notably, Lockheed Martin (Neustar's former parent) and other large defense contractors typically earn pre-tax profits under government contracts in the range of 8 to 10 percent of sales.[2] Such profit margins are consistent with the official contract rules of the U.S. Department of Defense ("DoD"), which sets "normal" profit margins between 5 and 9 percent and designates profitability targets ranging from 3 percent to 11 percent.[3] As reflected in the financial analysis accompanying the August 16 letter, which is based on Neustar's publicly available financial information, Neustar currently is earning profits that are many multiples of these targeted thresholds. Given the relatively less complex nature of the NPAC Contract as compared to most defense contracts, there would appear to be no justification for allowing the next LNPA(s) to earn profits at those levels.

Second, the FCC has long prescribed an interstate rate of return on capital of 11.25 percent for interstate access services provided by rate-of-return carriers,[4] and it has recently recognized that even that relatively modest return is too high in light of today's costs of capital. As a result, the Commission has tentatively concluded that the "authorized interstate rate of return should be [reduced to] no more than 9 percent."[5] Whether the Commission adopts a rate of return in the amount of 9 percent or an even lower amount, as various parties advocate, the critical point is that the expert agency has concluded that a rate of return in the range of 9 percent would be "high enough to provide confidence in the financial integrity of [rate-of-return] carrier[s]," and that the current 11.25 prescribed rate is "higher than necessary."[6] These conclusions underscore the need for NAPM to substantially reduce the price of the next NPAC Contract, as it would make no sense to allow the next LNPA(s) to earn profits well above the returns currently authorized for regulated telecommunications carriers—*i.e.*, the very entities that

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visited Sept. 15, 2013) (stating that the Regulatory Cost Recovery Charge imposed on AT&T Wireless customers recoups "Wireless Number Portability and Number Pooling" related costs, among others).

2 By way of illustration, Lockheed Martin reported operating profit as a percentage of total net sales of approximately 9 percent in each of 2012, 2011 and 2010. Lockheed Martin Corporation, Annual Report (Form 10-K), at 33 (Feb. 28, 2013) (calculating total consolidated operating profit as a percentage of total net sales).

3 *See* 48 C.F.R. § 215.404-71-2(c).

4 *See generally Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, 5 FCC Rcd 7507 (1990).

5 *Connect America Fund et al.*, Report and Order and Further Notice of Proposed Rulemaking, 26 FCC Rcd 17663 ¶ 1057 (2011).

6 *Id.* ¶ 1045 (internal citations and quotation marks omitted).

the LNPA was established to serve. As shown in the attached fair price analysis, contract prices in the $140 to $200 million range in the "High" and "Low" cases (note that the terms "High" and "Low" refer to estimated margins currently earned by Neustar, not the estimated "fair price"), respectively, would generate returns on sales and capital well above the relevant benchmarks just discussed. Importantly, this analysis already prices in the advantage of incumbency to Neustar, in that Neustar, unlike other bidders, has already invested some (and probably most) of the capital required, and therefore could generate returns similar to those shown in the attached analysis at an even lower price.

Although the ongoing RFP process theoretically should address the problem of Neustar's monopoly rents—namely, by generating interest among numerous entities that would submit bids that reduce the NPAC Contract price to a competitive level—it is not clear that the current RFP process will generate a truly competitive outcome. In particular, parties interested in submitting a bid to become an LNPA were given a mere two months to submit a proposal from the time the RFP documents became available. Recognizing that such an expedited timeframe would unfairly benefit the incumbent LNPA, NAPM subsequently extended the deadline, but only by two weeks.[7] Even assuming that the deadline extension would have been sufficient to enable new vendors to participate in the process, the damage likely already was done. The adoption of such a short RFP schedule likely signaled to a number of potential bidders that the process would be tilted heavily in favor of Neustar, thus discouraging them from participating at all, and resulting in a smaller bidding pool than otherwise could have been achieved.

I therefore urge you to consider the enclosed analysis and to re-evaluate the sufficiency of the current RFP process to ensure that the next NPAC Contract is priced at a level that will serve the public interest. Especially considering the current federal budget spending environment in Washington, D.C., including sequestration, it is hard to imagine that an RFP for a $1 billion-plus revenue opportunity for a quasi-governmental contract, if truly competitive in nature, would not generate robust interest and truly competitive offers. Please do not hesitate to contact me should you have questions regarding any of the foregoing information or the attachment.

Sincerely,

Matthew A. Brill dep

Matthew A. Brill
of LATHAM & WATKINS LLP

Attachment

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7 *See* NAPM LLC, NPAC RFI/RFP, https://www.napmllc.org/pages/npacrfp/npac_rfp.aspx (explaining that the purpose of the extension was "to promote competition and ensure that all potential offerors have … an adequate opportunity to compete," thus tacitly acknowledging that the expedited RFP schedule made it extremely difficult, if not impossible, for non-incumbents to participate in the LNPA process).

EXPLANATION OF NPAC CONTRACT "FAIR PRICE" ANALYSIS

The analysis that follows provides an estimate of a "fair price" for the next NPAC Contract utilizing the following assumptions:

- Marginal Cash Costs: These figures are taken from the analysis provided in the August 16 letter and represent the sum of "Carrier Services Direct Costs" and "Indirect Costs" as presented in that analysis.

- Initial Capital Investment: This is estimated at $50 to $75 million based on the following:

  - Neustar's net Property, Plant, and Equipment ("PP&E") account stood at $74 million as of December 31, 2010. Data from 2010 were used because Neustar made a number of significant acquisitions in 2011 that likely would have skewed any estimate of the capital expenditures required under the current NPAC Contract.
  - Significantly, even at year-end 2010, Neustar had a number of other businesses that contributed approximately 50 percent of Neustar's revenues, and thus likely represented a significant portion of its consolidated net PP&E accounts. Nevertheless, the "High" and "Low" case estimates assume initial capital requirements of $75 million and $50 million, respectively, for a new vendor (and Neustar's initial capital investment, as the incumbent, would clearly be significantly lower).

- Other Key Assumptions: The analysis then assumes:
  - (i) a seven-year contract life, consistent with the RFP;
  - (ii) seven-year depreciable life for the initial capital investment (conservatively assuming zero salvage value for such investment);
  - (iii) 38 percent tax rate, consistent with Neustar's reported effective tax rates;
  - (iv) zero percent annual growth in NPAC Contract fees, consistent with the RFP documents,[1] without assuming any cost reductions that would be passed on to NAPM in the form of lower NPAC Contract prices, as contemplated in the RFP documents;[2] and
  - (v) zero percent annual growth in cash operating expenses, again, not assuming any cost reductions as contemplated by the RFP documents.

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1 2015 LNPA RFP § 13.4 (Allocable Charges) ("The pricing model will be an annual fixed fee with no annual price escalators.").

2 *Id.* (Pricing Model) (stating that NAPM expects the "year-over-year cost of operating and administering the NPAC/SMS platform" will decrease as a result of technological developments and operational efficiencies, among other factors, and that the LNPA(s) must "agree[] to meet with the NAPM LLC on a mutually agreed upon schedule … to adjust the annual flat free for the remainder of the term of the Master Agreements to reflect any such savings achieved").

- NPAC Contract Fees: Based on the assumptions outlined above, the NPAC Contract Fees were set at levels that generated returns on sales of 8 to 9 percent (which is at the high end of the margins authorized for Department of Defense government contractors) and after-tax returns on capital in excess of 20 percent (well above the prescribed interstate rate of return authorized under the FCC's rules). Note that the analysis assumes unlevered returns; the returns on capital would be higher if a portion of the initial capital investment was assumed to be debt financed, consistent with Neustar's use of debt in its capital structure.

- Moreover, the analysis assumes zero terminal value, which is unrealistically conservative, as any winning bidder(s) presumably would assess some option value in connection with the potential to win any subsequent NPAC Contracts.

NPAC Fair Price Analysis
($ figures in millions)

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Low Case									
Initial Capital Investment		(75)							
NPAC Contract Fees			200	200	200	200	200	200	200
% Growth				0%	0%	0%	0%	0%	0%
Marginal Cash Costs			(172)	(172)	(172)	(172)	(172)	(172)	(172)
% Growth				0%	0%	0%	0%	0%	0%
Depreciation of Initial Capital Investment			(11)	(11)	(11)	(11)	(11)	(11)	(11)
Operating Profit			17	17	17	17	17	17	17
Return on Sales			***8.5%***	***8.5%***	***8.5%***	***8.5%***	***8.5%***	***8.5%***	***8.5%***
Taxes	38%		(6)	(6)	(6)	(6)	(6)	(6)	(6)
Aftertax Operating Profit			10	10	10	10	10	10	10
Aftertax Cash Flow		(75)	21	21	21	21	21	21	21
Aftertax Return on Capital	***21%***								

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
High Case									
Initial Capital Investment		(50)							
NPAC Contract Fees			140	140	140	140	140	140	140
% Growth				0%	0%	0%	0%	0%	0%
Marginal Cash Costs			(121)	(121)	(121)	(121)	(121)	(121)	(121)
% Growth				0%	0%	0%	0%	0%	0%
Depreciation of Initial Capital Investment			(7)	(7)	(7)	(7)	(7)	(7)	(7)
Operating Profit			12	12	12	12	12	12	12
Return on Sales			***8.6%***	***8.6%***	***8.6%***	***8.6%***	***8.6%***	***8.6%***	***8.6%***
Taxes	38%		(5)	(5)	(5)	(5)	(5)	(5)	(5)
Aftertax Operating Profit			7	7	7	7	7	7	7
Aftertax Cash Flow		(50)	15	15	15	15	15	15	15
Aftertax Return on Capital	***22%***								